

6 April 2020

Hon Grant Robertson
Minister of Finance
The Beehive
Wellington

Dear Hon Grant Robertson

As you are aware, on 21 March 2020, the Crown provided the Reserve Bank (the 'Bank') with an indemnity for the purchase of up to a maximum of \$30 billion New Zealand Government debt on the secondary market over the following 18 months, financed by central bank money. Following that decision, the Monetary Policy Committee (MPC) agreed on 22 March 2020 to approve a programme of large scale asset purchases (LSAP) of New Zealand Government debt to a total volume of \$30 billion over 12 months. This reflected the impact of the COVID-19 outbreak on the global and domestic economies, which compromised the MPC's ability to meet its economic objectives using its conventional monetary policy tool (a positive Official Cash Rate (OCR)).

The Bank began purchases under the LSAP programme on 25 March 2020. To date, the LSAP programme has been successful in improving conditions in the New Zealand Government debt market. Liquidity in the market has improved, bond yields have declined and the yield curve has stabilised relative to conditions a few weeks ago. This provides stimulus to the New Zealand economy as a well-functioning government bond market is essential for the pricing of other debt instruments in New Zealand and lowering Government bond yields lowers the interest rates faced by New Zealand households and businesses. As a result, the LSAP programme is helping the MPC achieve its economic objectives as specified in the remit and section 8 of the Reserve Bank of New Zealand Act (1989), namely: (a) achieving and maintaining stability in the general level of prices over the medium term; and (b) supporting maximum sustainable employment.

Over recent weeks, however, the Bank has observed signs of significant dislocation in other New Zealand debt markets, caused by a combination of the near-closure of global credit markets, domestic intermediaries reducing risk due to increased market volatility, and fund managers liquidating their holdings in order to meet redemptions.

There is particular concern about the dislocation and lack of liquidity in the market for New Zealand Local Government Funding Agency (LGFA) debt. LGFA debt provides a critical benchmark for non-government credit instruments in New Zealand, and in normal times is the most liquid part of this market. A persistent lack of liquidity would have a deep and lasting detrimental impact on the confidence in New Zealand's debt capital markets, which will increase interest rates in New Zealand more broadly and inhibit the transmission of monetary policy. This presents a threat to the achievement of the MPC's economic objectives.

I am therefore writing to you to request that the Crown indemnity provided to the Reserve Bank on 21 March 2020 be extended to cover losses associated with the purchase of up to \$3 billion of LGFA debt, in addition to the purchase of \$30 billion of New Zealand Government debt previously agreed. The Bank is not seeking a change to the existing 18 month duration in which assets purchased by the Bank are eligible under the indemnity. The Bank asks that LGFA debt purchased as a reinvestment of LGFA debt held within the LSAP programme, within or after the 18 month timeframe, be eligible under the indemnity.

This request is in accordance with the *Memorandum of Understanding between the Minister of Finance and the Reserve Bank of New Zealand regarding the use of alternative monetary policy tools* (MoU) dated 21 March 2020.

The case for purchasing LGFA debt under the LSAP programme has been assessed against the principles set out in the Bank's *Unconventional Monetary Policy Principles and Tools* document. As described above, purchasing this debt will help lower interest rates and improve the transmission and effectiveness of monetary policy. It will support market efficiency and financial stability by bringing confidence and stability to New Zealand debt markets, through the provision of much needed liquidity, currently unobtainable through normal market channels. In addition, it will not materially increase the public balance sheet risk associated with the LSAP programme and the Bank is operationally ready to purchase LGFA debt.

The LSAP programme would continue to be designed to minimise distortions in the Government debt market, as well as minimising distortions in other credit markets including the market for LGFA debt. The Bank will closely monitor the effect of its Government debt purchases on the functioning of financial and credit markets and on financial stability risks, and will adapt its purchase operations when necessary. The Bank will also continue to work with the Treasury's Capital Markets unit when planning operations under the LSAP programme.

The risk control framework, agreed with the Treasury following announcement of the LSAP programme on 23 March, will also be updated to reflect the risks associated with the purchase of LGFA debt. As with the purchase of New Zealand Government debt, the key financial risk relates to interest rate risk, which is influenced by the future path of the OCR. The Bank will face some credit risk when purchasing LGFA debt, however, this risk is relatively small given its high credit quality. We ask that the Crown indemnify the Bank against losses due to both the interest rate risk and credit risk that is associated with the purchase of LGFA debt under the LSAP programme.

The Bank will continue to report to the Treasury monthly on the transactions undertaken as part of the LSAP programme, including information on the scale of operations and the associated gains or losses associated with the purchase of each asset class. This information will also be included in the Bank's Annual Report and in more frequent public reporting, provided that information can be provided in a way that did not compromise the efficacy of the LSAP programme.

The MPC will continue to monitor the effectiveness of monetary policy, including the LSAP programme, and its broad impact on the economy and financial system. This includes an assessment of whether the current monetary policy settings provide the right amount of stimulus to meet the MPC's economic objectives. This analysis will be set out in the upcoming *May Monetary Policy Statement*. Should the MPC determine that a change in the scale, duration or asset classes included in the LSAP programme is necessary to meet its economic objectives, the Bank will write to you to request a change in the indemnity, as per the MoU.

I look forward to receiving your reply.

Yours sincerely

A handwritten signature in blue ink, consisting of a series of loops and a long horizontal stroke at the end.

Adrian Orr
Governor